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AZ CORP COMMISSION
DOCKET CONTROL

TO: Docket Control

FROM: *EGJ*
Ernest G. Johnson *EGJ*
Director
Utilities Division

DATE: August 8, 2002

RE: AMENDED STAFF REPORT FOR XO COMMUNICATIONS, INC. FOR A WAIVER OF THE PUBLIC UTILITY HOLDING COMPANIES AND AFFILIATED INTERESTS RULES AND NOTIFICATION OF THE TRANSFER OF CONTROL OF XO COMMUNICATIONS, INC. SOLE SHAREHOLDER OF XO LONG DISTANCE SERVICES, INC. AND XO ARIZONA, INC. FROM THE CRAIG O. MCCAW, FORSTMANN LITTLE, AND EXISTING SHAREHOLDERS GROUP TO THE FORSTMANN LITTLE, TELMEX, AND PROPOSED OTHER SHAREHOLDERS GROUP (DOCKET NOS. T-03601A-01-0965, T-03775A-02-0389, AND T-03601A-02-0389)

Attached is the Amended Staff Report for XO Communications, Inc. application for a waiver of the public utility holding companies and affiliated interests rules and notification of the transfer of control of XO Communications, Inc. sole shareholder of XO Long Distance Services, Inc. and XO Arizona, Inc. from the Craig O. Mccaw, Forstmann Little, and existing shareholders group to the Forstmann Little, Telmex, and proposed other shareholders group. Staff recommendations are listed in the attached Staff Report. Staff further recommends that a hearing not be held in this matter.

EGJ:REL:rdp

Originator: Ronald E. Ludders

Attachment: Original and ten copies

Arizona Corporation Commission
DOCKETED

AUG 08 2002

DOCKETED BY	<i>EGJ</i>
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Service List for: XO Communications, Inc.

Docket Nos. T-03601A-01-0965, T-03775A-02-0389, and T-03601A-02-0389

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AMENDED STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION

XO COMMUNICATIONS, INC.

DOCKET NOS. T-03601A-01-0965
T-03775A-02-0389
T-03601A-02-0389

APPLICATION
FOR APPROVAL OF A WAIVER OF THE PUBLIC UTILITY HOLDING COMPANIES
AND AFFILIATED INTERESTS RULES
AND
NOTIFICATION OF THE TRANSFER OF CONTROL OF XO COMMUNICATIONS, INC.
SOLE SHAREHOLDER OF XO LONG DISTANCE SERVICES, INC. AND XO ARIZONA,
INC. FROM THE CRAIG O. MCCAWE, FORSTMANN LITTLE, AND EXISTING
SHAREHOLDERS GROUP TO THE FORSTMANN LITTLE, TELMEX, AND PROPOSED
OTHER SHAREHOLDERS GROUP

AUGUST 2002

**EXECUTIVE SUMMARY
XO COMMUNICATIONS, INC.
DOCKET NO. T-03601A-01-0965**

On December 11, 2001, XO Communications, Inc. ("XO") filed an application for a permanent general waiver of the Arizona Corporation Commission ("Commission") Public Utilities Holding Company and Affiliated Interests Rules A.A.C. R14-2-801 through 806 ("Rules").

On May 24, 2002, XO Communications notified the Commission of the proposed transfer of ownership and control of XO and its operating subsidiaries Docket Nos. T-03775A-02-0389 and T-03601A-02-0389.

XO Arizona, Inc. ("XO Arizona") is a wholly owned subsidiary of XO Communications, Inc., a publicly traded Delaware corporation. XO Arizona is a non-dominant, facilities based carrier authorized by the Commission to provide competitive local exchange services (including switched and dedicated access services), intraLATA toll services and intrastate inter-exchange telecommunications services within the State of Arizona.

XO filed an application for a permanent general waiver of the Arizona Corporation Commission Public Utilities Holding Company and Affiliated Interests Rules A.A.C. R14-2-801 through 806. Rule R14-2-806 provides a waiver from Article 8. Rule R14-2-801 provides definitions under Article 8 and R14-2-802 defines Article 8's applicability. Therefore, Staff interprets XO's petition as a waiver from Rules R14-2-803 to 805. (See body of report for details.)

On May 14, 2002, the waiver request was heard at an Open Meeting of the Commission. The Commission expressed concern about the Recommended Opinion & Order and allowed the matter to be removed from the agenda so that XO could address these concerns.

Through its Counsel, a June 12, 2002 meeting was held with Staff in which XO proposed waiver language which mirrored that which was approved in the US WEST (nka Qwest) waiver granted in 1992 (Decision No. 58087).

The impact of the approval of the recommended waiver language will make moot the transfer of ownership and control of XO Communications, Inc. portion of this docket.

However, if the Commission rejects XO's request for a waiver, the transfer of ownership and control of XO Communications, Inc. should then be considered.

Staff believes that the merits of the proposed reorganization and re-capitalization of the public utility holding company does not impair the operating subsidiaries from providing their authorized telecommunications services in a competitive market.

If no waiver is approved, Staff recommends that the Commission approve XO's application for the planned reorganization of the public utility holding company.

Staff recommends that:

1. The Commission approve the waiver language proposed in the original Staff report.
2. In the alternative, Staff recommends that the Commission approve a waiver based on the 1992 US WEST waiver.
3. Staff further recommends that the Commission declare moot XO's application for re-capitalization of the public utility holding company.

Staff further recommends that the Commission approve XO's application without a hearing.

Staff further recommends that the Commission order that XO file items 1 and 6 through 11 of R14-2-803 as a late-filed supplement to the application within thirty (30) days of the effective date of the Commission's order in this matter.

Staff further recommends that if the aforesaid late-filed supplement is not filed, the Commission's approval of this application be automatically made null and void without further order of this Commission.

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Part I – The Waiver Request

Introduction

On December 11, 2001, XO Communications, Inc. ("XO" or Company") filed an application for a permanent general waiver of the Arizona Corporation Commission ("Commission") Public Utilities Holding Company and Affiliated Interests Rules A.A.C. R14-2-801 through 806 ("Rules"). Rule R14-2-806 provides a waiver from Article 8. Rule R14-2-801 provides definitions under Article 8 and R14-2-802 defines Article 8's applicability. Therefore Staff has interpreted XO's petition as a waiver from Rules R14-2-803 to 805.

XO is the parent of XO Arizona, Inc. ("XO Arizona") and XO Long Distance Services, Inc. ("XO Long Distance"), two companies with Certificates of Convenience & Necessity issued by the Commission Docket Nos. T-03601A-98-0417 and T-03775A-99-0494 respectively. On January 31, 2002, in Decision No. 64399, the Commission suspended the filing for one hundred twenty (120) days to give Staff sufficient time to review XO's proposal. Staff filed a Staff Report on March 9, 2002. On May 14, 2002, the waiver request was heard at an Open Meeting of the Commission. The Commission expressed concern about the Recommended Opinion & Order and allowed the matter to be removed from the agenda so that XO could address these concerns.

On May 24, 2002, XO notified the Commission of the proposed transfer of ownership and control of XO and its operating subsidiaries. On June 24, 2002, XO filed a Supplemental Application for Expedited Approval of Transfer. On June 26, 2002, XO filed a Supplemental Application of XO Arizona, Inc. and Affiliates for Expedited Approval of Transaction to transfer ownership and control.

Through its Counsel, a June 12, 2002, meeting was held with Staff in which XO proposed waiver language which mirrored that which was approved in the US WEST (nka Qwest) waiver granted in 1992 (Decision No. 58087).

XO Communications, Inc.

XO Communications, Inc. is a publicly traded Delaware corporation that, through its operating subsidiaries, provides bundled local and long distance as well as dedicated voice and data telecommunications services primarily to business customers. It has metro broadband fiber optic networks in more than 60 cities in the United States, including the top 30 cities, and serves 25 of the largest metropolitan areas in the United States. The Company also is one of the nation's largest holders of fixed wireless spectrum, covering 95 percent of the population of the 30 largest U. S. cities, and has deployed fixed wireless technology in 27 of these markets.

XO is authorized, through its subsidiaries, to provide intrastate interexchange services virtually nationwide, including in Arizona and is authorized to provide local exchange services in

approximately 30 states, including Arizona. The Company also offers domestic and international telecommunications services pursuant to FCC (Federal Communications Commission) Section 214 authorizations. The Company's international offering is incidental to its core domestic business.

XO Arizona, Inc.

XO Arizona, is a non-dominant, facilities based carrier authorized by the Commission to provide competitive local exchange services (including switched and dedicated access services), intraLATA toll services and intrastate inter-exchange telecommunications services within the State of Arizona.

Because of current market conditions, and the scarcity of funding for competitive telecommunications networks, XO is a party to what may be considered a "reorganization," pursuant to the Rules. XO seeks a waiver that would be applicable to it (XO Communications, Inc.) and all of its current and future affiliated entities.

In Arizona, XO Arizona competes directly with Qwest, the local exchange carrier, as well as numerous other competitive local exchange and inter-exchange carriers, such as AT&T, MCI and Sprint. XO Arizona does not have captive customers, and all of its customers are free to obtain telecommunications services from other carriers that provide the same services.

XO Long Distance, Inc.

In the 2001 annual report of XO Long Distance to the Commission, XO Long Distance did not generate any Arizona jurisdictional revenue.

The Company's Waiver Request

In its application, XO requests a "permanent general waiver" of the Commission's application of the Rules. XO believes that it should have a permanent general waiver of the Rules for several reasons. XO believes that the existing competitive market precludes cross subsidizing or commingling that would harm Arizona customers. XO asserts that it has no incentive or ability as a non-dominant carrier to charge unduly high or above-market prices that could be used to fund or subsidize unregulated affiliates.

XO also asserts that full compliance with the Rules, considering its organizational structure, would be unnecessarily burdensome. Because of this structure, XO believes that most of its transactions are national and do not impact Arizona customers. XO further claims that because its Arizona operations represent such a small percentage of its total revenue and investment, application of the Rules to XO would produce no benefit in relation to the burden the Rules would place on XO and the Commission.

During the May 14, 2002, Open Meeting the Commission expressed concern about the Recommended Opinion and Order indicating that there was no specific transaction before them for which to consider a waiver.

Since that time, the Company has notified the Commission of their proposed transfer of ownership and control of XO and its operating subsidiaries thereby presenting the opportunity for the Commission to consider granting a waiver.

The Purpose of the Public Utility Holding Companies and Affiliated Interests Rules

Prior to and during 1990, Arizona Public Service Company ("APS") formed a holding company, Pinnacle West Capital Corporation, and it acquired MeraBank. Huge losses were experienced by MeraBank, resulting in downgrades of APS's bond rating and increases in APS's cost of capital. At the same time, Southwest Gas Corporation purchased PriMerit, a savings bank, and Tucson Electric Power Company diversified into several non-utility related activities.

Decision No. 56844, dated March 14, 1990, first adopted the Public Utility Holding Companies and Affiliated Interests Rules found in Article 8 of the Commission's Rules. Attachment B to the Decision was a concise explanatory statement that described and explained the Rules. The statement explained that "Its [Article 8's] singular purpose is to ensure that ratepayers do not pay rates for utility service that include costs associated with the holding company structure, financially beleaguered affiliates, or sweetheart deals with affiliates intended to extract capital from the utility to subsidize non-utility operations."

R14-2-803

Rule R14-2-803 requires a utility or affiliate to give advance written notice of intent to organize or reorganize a public utility holding company. R14-2-801 broadly defines reorganization as "the acquisition or divestiture of a financial interest in an affiliate or a utility, or reconfiguration of an existing affiliate or utility's position in the corporate structure or the merger or consolidation of an affiliate or a utility." This can be interpreted to mean that every time XO or its affiliates create or divest themselves of a subsidiary, regardless of the business purpose or location of the subsidiary, a notice of intent would need to be filed with the Commission.

R14-2-804

Rule R14-2-804 (B), (C) and (D) require prior Commission approval of certain transactions undertaken by the utility including obtaining an initial financial interest in an affiliate, guaranteeing or assuming liabilities of affiliates or increasing or decreasing a financial

interest in an affiliate. Rule R14-2-804 (A) refers to Commission access to an affiliate's books and records. Staff does not recommend a waiver from this section.

R14-2-805

Rule R14-2-805 requires all public utility holding companies and Class A public utilities in Arizona to file their diversification plans annually. Along with these plans, the utilities must file other information including, but not limited to, financial statements for each subsidiary, a description of the plans for the utilities' subsidiaries to change business activities, an assessment of the effect of planned affiliated activities on the utility's capital structure, the bases upon which the holding company allocates costs, the dollar amount transferred between the utility and each affiliate, and most contracts between affiliates and the utility.

Recommendations – as to Part I – The Waiver

Staff believes that the recommendation filed with its original Staff Report is consistent with other waivers recently approved by the Commission and presents the strongest consumer safeguards because it deals directly with rates and charges on file with the Commission. Therefore, Staff recommends approval of the following waiver language:

- Rule R14-2-803. The Commission should grant XO a waiver from Rule R14-2-803 unless organization or reorganization could directly or indirectly result in or cause an increase in XO Arizona's maximum rate on file with the Commission for any competitive service.
- Rule R14-2-804. The Commission should grant XO a waiver from Rule R14-2-804 (B), (C) and (D) except for transactions that could directly or indirectly result in or cause an increase in XO's maximum rate on file with the Commission for any competitive service.
- Rule R14-2-805. The Commission should grant XO a waiver from Rule R14-2-805 unless diversification plans could directly or indirectly result in or cause an increase in XO Arizona's maximum rate on file with the Commission for any competitive service.

However, at the May 14, 2002 Open Meeting, the Commission directed Staff and the Company to meet and consider alternative language. The Company proposed wavier language (with appropriate name changes) similar to that approved in the 1992 US WEST waiver Decision No. 58087. Staff is listing this language as an option to the Commission but does not believe its emphasis thoroughly protects Arizona customers because it emphasizes Company costs and net operating expenses rather than the maximum rates allowed.

The following language is being proposed by the Company:

XO Arizona, Inc. its parent XO Communications, Inc. and all affiliates of XO Arizona, Inc. not regulated by the Commission, be required to file a notice of intent to organize or reorganize a public utility holding company only for those organizations or reorganizations where XO Arizona, Inc. is directly involved, and in all reorganizations or organizations that are likely to:

1. result in increased capital costs to XO Arizona, Inc.;
2. result in additional costs allocated to the Arizona jurisdiction; or
3. result in a reduction of XO Arizona, Inc.'s net operating income.

No cumulative threshold or "exempt" amount shall apply to any organization or reorganization planned by XO Arizona, Inc. its parent XO Communications, Inc, or any affiliate of XO Arizona, Inc. which would result in any or all of the three impacts listed above.

Part II – The Transaction

Impact of the Approval of the Waiver

If either Staff's or the Company's proposed recommended waiver language is approved, the transfer of ownership and control of XO Communications, Inc. will become moot.

However, if the Commission rejects XO's request for a waiver, the transfer of ownership and control of XO Communications, Inc. should be approved.

The Company's Transfer of Ownership and Control of XO Communications, Inc. Request

Currently, XO is owned by three entities. These entities and their percentage of ownership are as follows: Craig O. McCaw (51%), Forstmann Little (8%), and other existing shareholders (41%). The attached organization chart titled "Current" (Attachment A) shows the details of the present ownership structure of the holding company group. This chart also identifies all affiliates and their relationships within the current ownership structure of the holding company group.

If the proposed transfer of ownership and control of XO and its operating subsidiaries is approved by the Commission, the resultant effect of the ownership structure will be that four entities will own XO. The attached organization chart titled "Post-Transfer of Control" (Attachment B) shows the outcome of the proposed transfer of ownership and control. This organization chart also identifies all affiliates and their relationships within the post ownership structure of the holding company group.

The Commission does have jurisdiction over the proposed transaction. The two XO subsidiaries, XO Long Distance and XO Arizona are Arizona public service corporations. The

planned re-capitalization and reorganization of the public utility holding company does not affect certificated Arizona public service corporations. However, according to Rule R14-2-802, Public Utility Holding Companies and Affiliated Interests Rules apply to all Class A investor-owned utilities. In the annual report of XO Arizona to the Commission, XO Arizona generated more than \$1.0 million of Arizona jurisdictional revenue. Based on Rule R14-2-103.B.1, XO Arizona is a Class A investor-owned utility. The Parent Company, XO Communications, Inc. is an Arizona public utility holding company. As a result, XO Arizona and XO Communications, Inc., are subject to Rules R14-2-801 through 805.

Rule R14-2-803 governs the organization of public utility holding companies. Any utility or affiliate intending to organize a public utility holding company or reorganize an existing public utility holding company is required to notify the Commission's Utilities Division. The notice of intent needs to include the following information:

1. The names and business addresses of the proposed officers and directors of the holding company;
2. The business purposes for establishing or reorganizing the holding company;
3. The proposed method of financing the holding company and the resultant capital structure;
4. The resultant effect on the capital structure of the public utility;
5. An organization chart of the holding company that identifies all affiliates and their relationships within the holding company;
6. The proposed method for allocating federal and state income taxes to the subsidiaries of the holding company;
7. The anticipated changes in the utility's cost of service and the cost of capital attributable to the reorganization;
8. A description of diversification plans of affiliates of the holding company;
9. Copies of all relevant documents and filings with the United States Securities and Exchange Commission and other federal or state agencies.
10. The contemplated annual and cumulative investment in each affiliate for the next 5 years, in dollars and as a percentage of projected net utility plant, and an explanation of the reasons supporting the level of investment and the reasons this level will not increase the risks of investment in the public utility.
11. An explanation of the manner in which the utility can assure that adequate capital will be available for the construction of necessary new utility plant and for the improvement in

existing utility plant at no greater cost than if the utility or its affiliate did not organize or reorganize a public utility holding company.

In its notification filing, XO provided information required in items 2 through 5. XO did not provide information required in items 1 and 6 through 11. As a result, XO did not provide all of the information required in Rule R14-2-803.

Summary

While having all required information would be of some benefit to Staff in evaluating the proposed transaction, the lack of having all required information does not erode the value of the reorganization. Currently, XO has more than \$500 million available to fund operations while the bankruptcy proceeding is pending. The reorganization will enhance the capitalization structure of XO. A new issue of common shares will be purchased by the investors (Forstmann Little and Telmex), each of whom will pay \$400 million in cash. This represents a capital infusion of \$800 million. Equity will consist of each investor's 40 percent common stock interest with the balance of 20 percent divided between management (approximately 2 percent) and other holders (18 percent). Upon completion of restructuring transactions, XO would have no more than \$1 billion of outstanding senior secured debt and modifications to its credit facility will extend the scheduled maturity dates of outstanding loans by three years. XO believes that modifications to be made to certain financial covenants and other minor amendments do not require approval by the Commission as these changes do not directly affect the guarantees and security interest given by XO's utility entities operating in Arizona and cites A.R.S. § 40-301(D) as support. In its application, XO further states that should the Commission determine that additional approval is required, such approval is hereby respectfully requested.

Staff believes that the merits of the proposed reorganization and re-capitalization of the public utility holding company does not impair the operating subsidiaries from providing their authorized telecommunications services in a competitive market. If the operating subsidiaries were not operating in a competitive environment or operating as a monopoly, then complete information such as the anticipated changes in the utility's cost of service and the cost of capital attributable to the reorganization, as required in item 7, would be needed to protect the consumer from high or unfair prices. However, in a competitive market, where many providers furnish the same telecommunications services, high or unfair prices are controlled by competition. This is especially true for companies like XO that are not dominant carriers. Generally speaking, when there are many providers in a market, there will be a provider(s) willing to furnish a comparable service for a fair, reasonable or low market price.

Recommendations – as to Part II – The Transaction

If the Commission does not approve XO's request for a permanent waiver of the Public Utility Holding Companies and Affiliated Interests Rules, then:

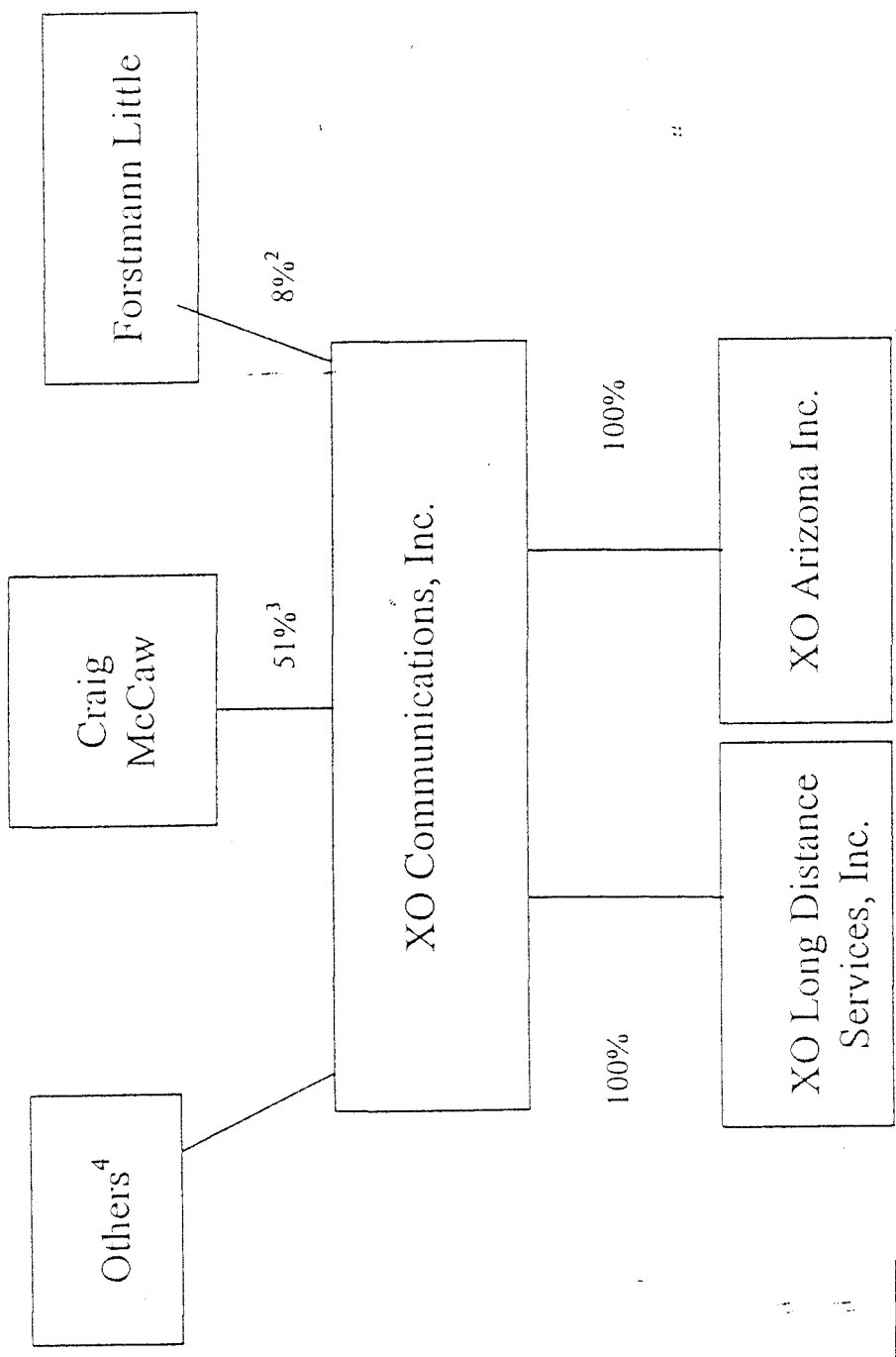
Staff recommends that the Commission approve XO's application for the planned reorganization of the public utility holding company.

Staff further recommends that the Commission approve XO's planned re-capitalization of the public utility holding company.

Staff further recommends that the Commission order that XO file items 1 and 6 through 11 of Rule R14-2-803 as a late-filed supplement to the application within thirty (30) days of the effective date of the Commission's order in this matter.

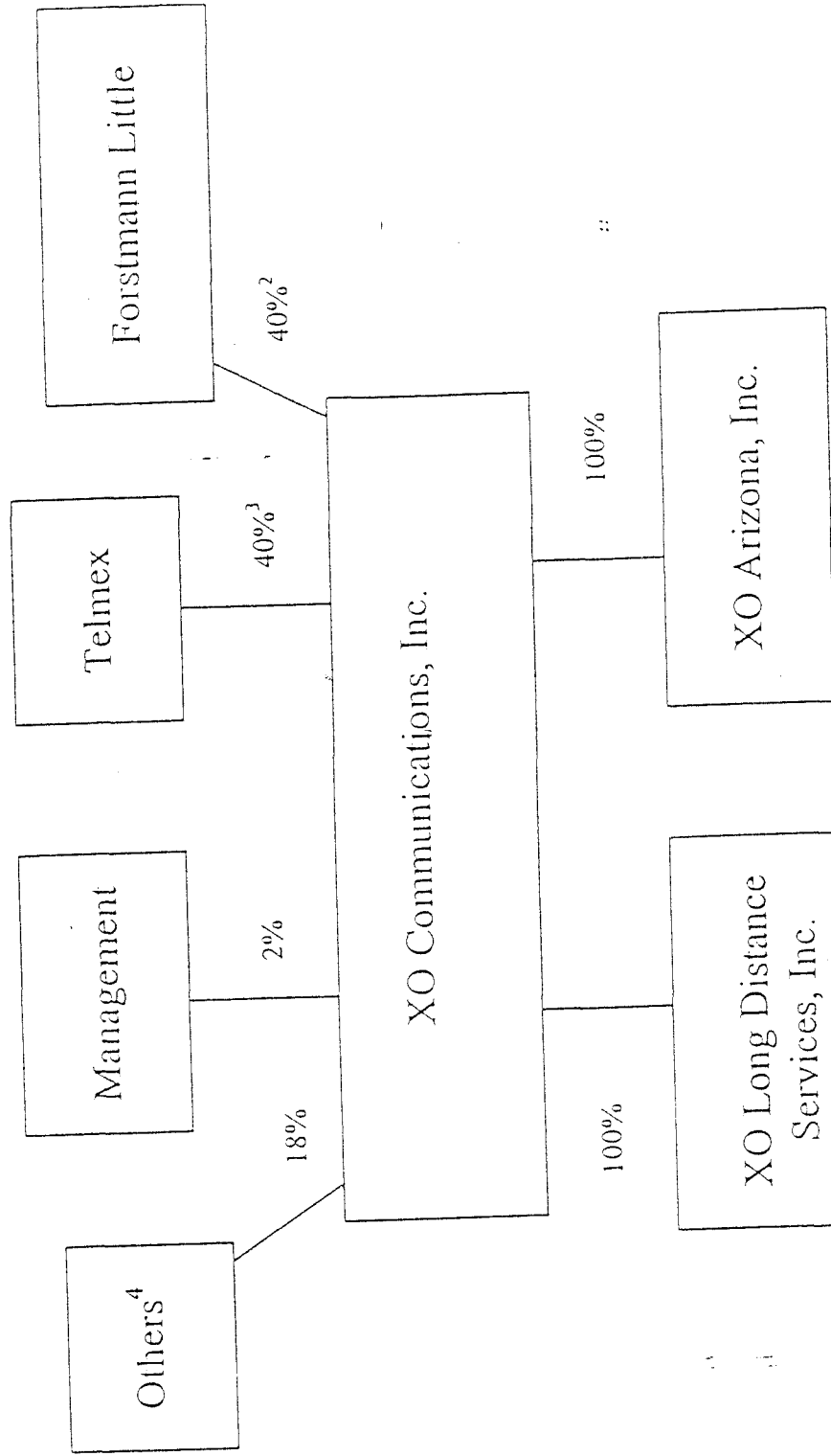
Staff further recommends that if the aforesaid late filed supplement is not filed, the Commission's approval of this application be automatically made null and void without further order of this Commission.

Current¹



1. These diagrams show ownership as approximate percentages of the voting interests in XO.
2. Forstmann Little & Co.'s current interest is held primarily by Forstmann Little & Co. Equity Partnership-VI, L.P. and Forstmann Little & Co. Subordinated Debt and Equity Management Buyout Partnership-VII, L.P. Minor interests held by persons affiliated with Forstmann Little & Co. also are included.
3. Craig McCaw currently controls XO through his ownership interest in Eagle River Investments, L.L.C., through other holdings of XO securities and pursuant to various voting arrangements, the primary one with shareholder Wendy P. McCaw, his former wife. Mr. McCaw holds a proxy to vote the number of shares of XO stock held by Mrs. McCaw necessary for Mr. McCaw to hold 51% of the interest in XO.
4. No individual shareholder holds a voting interest greater than 10%.

Post-Transfer of Control¹



1. Because negotiations with various parties in connection with the restructuring of XO are ongoing, each Investor's interest is an approximation.
2. Forstmann Little & Co. Equity Partnership-VII, L.P. will hold approximately 25%, and Forstmann Little & Co. Subordinated Debt and Equity Management Buyout Partnership-VIII, L.P. will hold approximately 15%.
3. Telmex's investment is through its wholly owned subsidiary, Controladora de Servicios de Telecomunicaciones, S.A. de C.V., which owns Teninver, S.A. de C.V., which will own approximately 40% of XO.
4. It is not anticipated that any individual shareholder will hold a voting interest greater than 10%.